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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA,
Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,
Respondent.

BRIEF OF RESPONDENT

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UNITED STATES OF AMERICA,
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ATLAS LIFE INSURANCE COMPANY,
Respondent.

BRIEF OF RESPONDENT

Question Presented

In Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code, Congress provided that if in any case the application of the statutory formulae for taxing life insurance companies "results in the imposition of tax on" state and municipal bond interest, adjustments "shall be made to the extent necessary to prevent such imposition." It is conceded that respondent's Federal income tax liability determined without making any adjustments under Sections 804(a)(6) and 809(b)(4) would be increased solely because of the receipt of interest on state and municipal bonds. The question presented is whether in enacting these sections Congress intended to eliminate any such increase in

a life insurance company's tax liability so as to preserve the traditional immunity of state and local bond interest from Federal taxation and to avoid placing an economic burden on the receipt of such interest.

If this was the intent of Congress, as the Court of Appeals held, there is no further question as to the meaning of Sections 804(a)(6) and 809(b)(4), and no constitutional question can arise as to the scope of the immunity of state and municipal bond interest from Federal taxation.

Statutes Involved

Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, § 2, 73 Stat. 112, 26 U.S.C. (Supp. V, 1959-64).

"SEC. 804. TAXABLE INVESTMENT INCOME.

"(a) IN GENERAL.—

* * * * *

"(6) EXCEPTION.—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

"(A) any interest which under section 103 is excluded from gross income,

"(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

"(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition."

* * * * *

"SEC. 809. IN GENERAL.

* * * * *

"(b) GAIN AND LOSS FROM OPERATIONS.—

* * * * *

"(4) EXCEPTION.—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

"(A) any interest which under section 103 is excluded from gross income,

"(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

"(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition."

Statement

Since 1921 the tax laws have provided methods, uniform for all companies, for determining the deduction allowed to life insurance companies in computing their taxable income for the annual increases in reserves necessary to meet policyholders' claims—such increases being the major business expense of life insurance companies.

The Revenue Act of 1921 provided that the deduction should be determined by applying a rate of 4% to each company's reserves; however, the deduction was to be reduced by the amount of state and municipal bond interest received by the company. In *National*

Life Ins. Co. v. United States, 277 U. S. 508 (1928), a decision brought to the attention of Congress when considering the Act here involved, this reduction of the reserve deduction was held to be a tax on state and municipal bond interest which Congress had no power to impose. Congress then deleted the reduction provision from the statute, and since that time Congress has consistently provided a method of taxation for life insurance companies pursuant to which their tax liabilities, like those of all other taxpayers, have not been affected by an individual company's receipt of state and municipal bond interest.

In 1958, when a comprehensive revision in the taxation of life insurance companies was undertaken, the House of Representatives initially passed a bill which provided that the deduction in respect of reserve liability increases would be reduced by that portion of a company's state and municipal bond interest equal to the ratio that the reserve deduction bore to the company's total investment income. This provision was severely criticized when the bill reached the Senate Finance Committee for two distinct, but related, reasons. The marketability of state and municipal bonds would be adversely affected if an economic burden were for the first time placed by the tax laws on the receipt by life insurance companies of interest on such bonds. And the basic immunity of state and municipal bonds from Federal income taxation affirmed in *National Life* and consistently followed by Congress in all subsequent statutes would be upset. Responding to this criticism, the Senate Finance Committee added the

adjustment provisions of Sections 804(a)(6) and 809 (b)(4) to the bill. The subsequent debates in both Houses of Congress on the bill containing the adjustment clauses confirm Congress' understanding that the traditional exemption of state and municipal bond interest would be preserved under the new law even if the basic taxing formula had to be adjusted to accomplish this.

Under the Life Insurance Company Income Tax Act of 1959 as finally enacted, the company's investment income is divided into the "policyholders' share" and the "company's share". Only the "company's share" is included in its taxable income, which is determined principally in two phases, "taxable investment income", which includes only income from investments, and "gain from operations", which includes underwriting income as well as investment income. (If "gain from operations" is larger than "taxable investment income", 50% of the excess is included in "life insurance company taxable income".[1]) The "policyholders' share", although labeled an exclusion from income, is in reality a deduction allowed on account of increases in reserve liabilities needed to meet policyholders' claims. The amount of this exclusion is separately computed by applying certain earnings rates or interest rates to the company's reserve liabilities. Since the total amount excluded from income as the "policyholders' share" is relatively constant, as investment income increases a smaller percentage of

[1] The other 50% of the excess is included in taxable income if and when distributed to shareholders. This is known as the "phase 3" tax base.

investment income is allocable to the "policyholders' share" and a larger percentage is taxable to the company as the "company's share."

A detailed description of the applicable provision of the Life Insurance Company Income Tax Act of 1959 is contained in Appendix A at pp. 59-63.

During the year 1958, respondent received $36,637.79 of state and municipal bond interest. If the definitions contained in the Act were applied without adjustments and this interest were included in the investment income which is divided between the "policyholders' share" and the "company's share", a higher percentage of each and every item of income from investments would be included in the "company's share" and taxed to the company. Although the statutory formula allows a deduction for the amount of state and municipal bond interest included in the "company's share", no deduction is allowed for the increased amount of the taxable items of investment income that would be taxed to the company by reason of the receipt of the state and municipal bond interest. In effect, as is conceded, the exclusion or deduction from taxable income of the amount necessary to satisfy increases in reserve liabilities is reduced by a pro rata portion of state and municipal bond interest. In respondent's case this has the result of increasing its Federal income tax liability by $11,252.19 by reason of its receipt of $36,637.79 of state and municipal bond interest. The marginal rate of taxation on such interest is 29.1%. (R. 45.)

Summary of Argument

In Sections 804(a)(6) and 809(b)(4), Congress provided that adjustments shall be made if the application of the statutory definitions "results in the imposition of tax" on state and municipal bond interest. In providing for such adjustments, Congress was concerned that no economic burden be placed upon the receipt of such interest. The economic effect which Congress understood would not occur after enacting the adjustment clauses plainly would exist if by reason of the receipt of state and municipal bond interest respondent's tax burden would be increased. It is conceded that such an increase would take place in respondent's case. The plain language of Sections 804(a)(6) and 809(b)(4) commands that adjustments be made.

On several occasions since this Court's decision in the *National Life* case, the Treasury Department has sought to find a way to impose a tax on the state and municipal bond interest received by life insurance companies. In each instance, Congress has resisted these attempts and has made it clear that the immunity of state and municipal bond interest from Federal income taxation enjoyed by other taxpayers is to be enjoyed without dilution by life insurance companies consistent with the standards set forth in *National Life* and other similar cases.[2] As the Court of Appeals found (R. 113; 333 F.2d at 398), Congress in enacting Sections 804(a)(6) and 809(b)(4) legislated with an eye to the decision in *National Life*. If the receipt of state and

[2] These include the cases cited with approval in *National Life* and the decision in *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930), all of which are discussed *infra* at pp. 39-42.

municipal bond interest results in an increase in tax, as it does in the instant case, under *National Life* a tax is imposed on state and municipal bond interest and Congress intended the adjustment clauses to apply.

Petitioner has attempted to justify the operation of the statutory formulae without the adjustment clauses on the ground that a deduction for an expense is merely being allocated between taxable income and non-taxable income. Since only the portion "allocated" to the non-taxable income is disallowed as a deduction, petitioner concludes that there is no imposition of tax on state and municipal bond interest. Petitioner's argument ignores the fact that the expense being allocated—the annual increase in reserves necessary to provide for policyholders' claims—is an expense of doing business as a life insurance company which would be incurred whether or not tax-exempt interest has been received. The annual deduction for this expense is nothing more than the application of accrual accounting to the life insurance business. It affords no "unique tax advantage" (P. Br. 15).[3]

This expense is not incurred in earning tax-exempt income, and it does not vary with the amount of such income. To "allocate" such an expense to tax-exempt income would be a novel and radical departure from the policy followed by Congress in the tax laws and by this Court in *National Life*. The denial of deductions under these circumstances amounts to the inclusion of tax-exempt interest in gross income. Far more is at

[3] A life insurance company can no more be described as an "80% tax-exempt taxpayer" (P. Br. 64-65 n.25) than an industrial company which incurs expenses in carrying on its business equal to approximately 80% of its gross income. Both are "fully taxable" on their net income.

stake than the "reasonableness" of an apportionment (P. Br. 29). The basic exemption of state and municipal bond interest from Federal income taxes is placed in question by petitioner's position here.

Petitioner's "allocation" argument deprives the adjustment clauses of any economic substance. Petitioner's sole explanation for the clauses is the self-contradictory assertion that Congress wished to prevent constitutional litigation over whether state and municipal bond interest is exempt from Federal taxation, but only if it should be determined that a tax is imposed on such interest. Respondent agrees that Congress intended to avoid constitutional litigation involving the sensitive area of intergovernmental immunities. This can be done, however, only if the standard of exemption to be applied is the traditional standard affirmed in *National Life*.

If the rationale of *National Life* is to be disregarded, this Court must consider whether the "allocation" of unrelated expenses to tax-exempt interest is constitutionally permissible. This cannot be done without a thorough examination of the nature and scope of the constitutional exemption of state and municipal bond interest. If an economic burden on the receipt of such interest can be imposed to this extent—in this case a 29.1% burden—where is the line to be drawn? There is no occasion for the Court to reach such important questions. Congress was aware of this Court's views as announced in *National Life*. It did not question these views. On the contrary, it took affirmative action by enacting Sections 804(a)(6) and 809(b)(4) to ensure that the traditional immunity of state and municipal bond interest as understood by it in the light of that

decision would not be disturbed and to make it clear that it did not wish to provoke constitutional litigation under the Life Insurance Company Income Tax Act of 1959 which would bring into issue the extent of this immunity. The traditional immunity can be preserved only if the adjustment clauses are applied to eliminate the increase in respondent's tax that occurs solely because of the receipt of state and municipal bond interest, as ordered by the Court of Appeals.

ARGUMENT

I

Sections 804(a)(6) and 809(b)(4) Apply Where an Increase in Tax Would Result From the Inclusion of State and Municipal Bond Interest in the Tax Computation of a Life Insurance Company.

Sections 804(a)(6) and 809(b)(4) were added to the Life Insurance Company Income Tax Act of 1959 in order to ensure above all else that the statutory formulae for taxing life insurance companies would not result in an economic burden being placed upon state and municipal bond interest and that no departure would be made from the traditional policies of protecting such bonds from impairment by Federal taxation. The setting in which these provisions were enacted can best be understood by a brief review of the prior history to which Congress' attention was directed.

A. Tax Legislation and Judicial Decisions Prior to the 1959 Act.

A method for determining the reserve liability deduction for life insurance companies which was uni-

form for all companies was first provided in the Revenue Act of 1921.[4] The deduction was equal to the amount by which 4 percent of the mean of each company's reserve funds required by law (the computation of which was not affected by tax-exempt interest) exceeded the company's tax-exempt interest. Revenue Act of 1921, ch. 136, § 245(a)(2), 42 Stat. 261.

In *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928), the Court recognized that by diminishing the 4 percent deduction which would have been fully deductible from National Life's taxable income if it had not received any tax-exempt income, National Life was required to pay an increased tax because of the receipt of state and municipal bond interest. The Court held that this resulted in the taxation of the exempt income contrary to both the statutory exemption afforded under Section 213(b)(4) of the Revenue Act of 1921, ch. 136, 42 Stat. 238 (comparable to Section 103 of the Internal Revenue Code of 1954) and the Constitution of the United States, and that it could not be given effect. In its opinion, the Court said:

> "If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because

[4] Prior to 1921 the deduction was related to reserve additions required by law or found by the Commissioner to be required for the protection of policyholders. The uncertain meaning of these provisions was found in 1921 to be confusing and productive of continued litigation. Subcommittee on the Taxation of Life Insurance Companies of the House Ways and Means Committee, A Preliminary Statement of Facts and Issues With Respect to the Federal Taxation of Life Insurance Companies, 83rd Cong., 2d Sess. 18-19 (1954).

he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted. . . .

"The burden from which federal and state obligations are free is the one laid upon other property. To determine what this burden is requires consideration of the mode of assessment, including, of course, deductions from gross values. What remains after subtracting all allowances is the thing really taxed.

". . .

"Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others." 277 U. S. at 519, 520, 522.

In the Revenue Act of 1932, ch. 209, § 203(a)(2), 47 Stat. 224, the provision reducing the deduction for reserve liability increases by the full amount of tax-exempt interest was dropped from the statute.[5] At the same time the statutory rate used to determine the reserve deduction was reduced by Congress from 4 percent to 3¾ percent for the purpose of restoring the overall tax base to substantially the same status as it had been prior to the decision in *National Life*. See *Hearings Before the Senate Finance Committee on H. R. 10236*, 72d Cong., 1st Sess. 332 (1932). There was no suggestion at that time that the decision in *National Life* could be overcome simply by providing that the reserve deduction should be reduced by an allocable portion of tax-exempt interest instead of the

[5] After the decision in *National Life*, the regulations under the Revenue Acts of 1921, 1924 and 1926 were amended to provide that life insurance companies were entitled to deduct 4 percent of their reserve funds "without any abatement on account of tax-exempt interest." T. D. 4231, VII-2 Cum. Bull. 299, 300 (1928).

full amount of such interest. It was clear that this would not be permitted.

In *National Life* the Court had referred with approval to *Packard Motor Car Co.* v. *City of Detroit*, 232 Mich. 245, 205 N. W. 106 (1925), and in summarizing that case it had noted that deductions under the property tax there held invalid had been reduced by only a proportionate share of United States government obligations. And in *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930), a similar method of reducing deductions under a state ad valorem property tax applicable to insurance companies had been held invalid by the Court on the authority of *National Life*. In its opinion in *Gehner*, the Court said:

> "It would be competent for the State to permit a less reduction or none at all. But where as in this case the ownership of United States bonds is made the basis of denying the full exemption which is accorded to those who own no such bonds this amounts to an infringement of the guaranteed freedom from taxation. It is clear that the value of appellant's government bonds was not disregarded in making up the estimate of taxable net values. That is in violation of the established rule. *Nat'l. Life Ins. Co.* v. *United States, supra. Northwestern Ins. Co.* v. *Wisconsin*, 275 U.S. 136. *Miller* v. *Milwaukee*, 272 U.S. 713." 281 U.S. at 321-22.

Furthermore, *National Life* had been reaffirmed in *Denman* v. *Slayton*, 282 U. S. 514 (1931), decided the next term after *Gehner* with the opinion for the Court being written by the same Justice who wrote the Court's opinion in *National Life*. The statute in *Slayton* disallowing deductions for interest on indebtedness

"incurred or continued to purchase or carry" tax-exempt securities was indeed a logical extension of *National Life*, for if tax-exempt income is excluded from the tax computation, expenses directly connected with the earning of such income should also be excluded. The Court recognized, however, that this was entirely different from denying deductions for expenses which would have been incurred regardless of the receipt of tax-exempt income. Stating that these were the circumstances present in *National Life*, the Court reiterated the holding in that case without purporting to limit the holding in any respect.[6]

In 1942 the Treasury Department initially proposed that the reserve liability deduction should continue to be determined by applying a statutory rate (to be reduced from 3¾% to 3¼%) to the individual company's reserves, but that the deduction should be reduced "by the percentage that tax-exempt interest bears to total investment income". *Hearings Before the House Ways and Means Committee on Revenue Revision of 1942*, 77th Cong., 2d Sess. 86 (1942). This proposal was objected to as violating *National Life*. *Id.* at 3211. At the same time the Treasury Department proposed to Congress that the statutory provisions exempting state and municipal bond interest from Federal income taxation should be repealed. *Id.* at 8; *Hearings Before the Senate Finance Committee on H. R. 7378*, 77th Cong., 2d Sess. 3-4 (1942). The whole question of Congressional policy with respect to the

[6] *Helvering* v. *Independent Life Ins. Co.*, 292 U. S. 371 (1934), which applied the same principle as *Slayton* and distinguished *National Life* for the same reason given in the *Slayton* opinion, is discussed *infra* at pp. 47-48.

exemption of such interest was debated at length in hearings before both the House Ways and Means Committee and the Senate Finance Committee. Both committees turned down this proposal.

The reserve liability deduction for life insurance companies that was finally adopted in the Revenue Act of 1942, ch. 619, § 163, 56 Stat. 870, was expressed as a percentage of net investment income. The percentage was computed by the Secretary of the Treasury for the entire life insurance industry, and each company applied the percentage to its own investment income to determine the amount to be deducted. While tax-exempt interest was taken into account in the formula for determining the percentage to be applied on an industry-wide basis, the individual company's tax liability was not affected by the fact that it received more or less tax-exempt interest than the industry-wide average used in the computation.

The deduction continued to be determined by similar methods under various formulae through 1957.[7] Thus, from 1942 through 1957, no question could arise as to whether a tax was imposed on the tax-exempt interest received by an individual company, since any individual company could obtain the full tax benefit of the exemption on any state and local bonds held by it.

B. Legislative History of the 1959 Act.

For many years prior to 1958, extensive studies were made by the Treasury Department, Congress and the

[7] These formulae are described in Report on the Taxation of Life Insurance Companies By the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee, 85th Cong., 2d Sess. 2, 4-5 (1958).

life insurance industry of proposals for establishing an individual company basis for determining the deduction for reserve liability increases.[8] It was also proposed that life insurance companies, which had since 1921 calculated their tax liabilities on the basis of investment income alone, should be taxed on the basis of their total income, including net gains from insurance operations resulting from favorable experience with mortality and expense assumptions. A subcommittee of the House Ways and Means Committee appointed to study the problem concluded that an individual company basis for determining the deduction was desirable, but only if the deduction was based on a method which was not affected by variations between companies in the assumptions used in calculating reserve liabilities for state reporting purposes.[9]

The plan ultimately approved by the sub-committee at the suggestion of the Treasury Department and passed by the House of Representatives established the basic approaches to the tax computation reflected in the Act that was finally adopted. The taxable income of the company was primarily its net investment income, but if it had a net gain from its overall operations in excess of taxable investment income, 50 percent

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[8] *E.g.*, Subcommittee on Taxation of Life Insurance Companies of the House Ways and Means Committee, A Preliminary Statement of the Facts and Issues With Respect to the Federal Taxation of Life Insurance Companies, 83d Cong., 2d Sess. (1954). The *National Life* decision was usually referred to in these studies. See *id.* at 19.

[9] Report on the Taxation of Life Insurance Companies By the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee, 85th Cong., 2d Sess. 5 (1958).

of the excess was also included in taxable income.[10] Reserve liability increases based on assumed interest rates were used only in computing gains from operations; in the more important calculation of "taxable investment income", the deduction was determined by a formula based in part on the company's actual earning rates.[11] Both phases of the House bill contained provisions, which came to be known as the "add-back" clauses, pursuant to which the deductions for reserve liability increases were reduced by the proportion of the state and municipal bond interest received by the company that was equal to the ratio that the reserve liability requirements bore to total investment income. H. R. 4245, 86th Cong., 1st Sess., §§ 805(e), 809(f)(1), reproduced in *Hearings Before the Senate Finance Committee on H. R. 4245*, 86th Cong., 1st Sess. 7, 9-10 (1959) [hereinafter called *"Senate Hearings"*]. The bill did not contain any adjustment provisions comparable to Sections 804(a)(6) and 809(b)(4).

In the Senate Finance Committee, representatives of state and local governments complained that the increase in the tax liability of life insurance companies

[10] In both the House bill and the final Act, if "gain from operations" is less than "taxable investment income", then "life insurance company taxable income" includes only "gain from operations". In most cases, however, "gain from operations" is limited to "taxable investment income" less $250,000 under Section 809(f). Petitioner overlooks this important limitation when it states that "gain from operations" has the "greater impact" on the company's final taxable income. P. Br. 3-4 n.l. The Senate Finance Committee estimated that $460 million of the $500 million expected to be derived for 1958 under the bill which became the final Act would be attributable to "taxable investment income". S. Rep. No. 291, 86th Cong., 1st Sess. 12 (1959).

[11] In the Act finally adopted, actual earnings rates are used exclusively in determining "taxable investment income".

which would result from the receipt of state and municipal bond interest would increase the cost of borrowing by state and municipal governments since a higher interest rate would be required to make their obligations competitive with fully taxable obligations. Referring to this aspect of the House bill, Senator Talmadge stated to the Committee:

> "One of my constituents goes so far as to make this assertion: Under present market conditions, taxable utility bonds are currently offered to yield about 4.6. Under the proposed new tax bill in order to be comparatively attractive municipal bonds would have to yield approximately 4.10. This excludes the great bulk of municipal bonds currently being offered in the range of three, three and three-quarters. If full tax-free status is granted his company would be interested in this type of security, on yields as low as approximately 3½ percent.
>
> "If his contention is correct, that will vastly affect the market authority of the county bonds and others.
>
> ". . .
>
> "It would be a very important thing not only to insurance companies but to counties, States, and municipalities that build hospitals, school buildings, and things of that type, if they suddenly found their interest rate raised to the degree of maybe three-quarters of 1 percent, This being true when trying to be competitive in the market when selling their obligations. This is important not only to the insurance companies and the taxpayer, but it is of vast importance also to those subdivisions of State governments in States at the

present time which have tax-exempt status." *Senate Hearings* pp. 45-46, 47-48.[12]

As petitioner acknowledges (P. Br. 64), it was made overwhelmingly clear to the members of the Senate Finance Committee that the increase in tax necessarily resulting from the "add-back" provisions of the House bill would make state and municipal bonds a less attractive investment for life insurance companies. It was also recognized, as Senator Talmadge indicated in the statement just quoted, that because of the lower yield on such bonds no special advantage was derived by life insurance companies from the exemption of such interest from Federal income taxes.

There is nothing in the record of the hearings to support petitioner's assertion (P. Br. 75) that the majority

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[12] Senator Butler said in a statement inserted in the record of the hearings:

> "Permanent provisions of [a] statute taxing the interest on State and local bonds held by life insurance companies would have a serious depressant effect upon the State and municipal bond market at a time when many communities of our Nation are finding it difficult, if not impossible, to sell such securities to meet the cost of much-needed capital improvements." *Senate Hearings* 700.

Senator Butler's statement also referred to "the many statements the Finance Committee has received from municipal groups warning of the grave danger this proposal holds in store for them." *Senate Hearings* 701. See, for example, the following telegram from the Mayor of Jacksonville, Florida to Senator Byrd, the Chairman of the Senate Finance Committee:

> "Urgently request Senate avoid impairing municipal bond market and increasing cost of municipal financing through indirect repeal of section 103 in proposed life insurance company tax bill, H. R. 4245. Such action would have very serious consequences for Jacksonville's progressing urban redevelopment program, a program being financed entirely through our own credit and revenues and without 1 penny of Federal aid." *Senate Hearings* 593.

See also *Senate Hearings* 699-700.

of the members of the Committee agreed with the Treasury Department's view that the "add-back" provisions of the House bill were necessary in order to be "fair". No member of the Committee questioned the soundness of the policy of complete exemption long followed by Congress, although it was brought out early in the hearings that the "apportionment of deductions" would necessarily contravene that policy. On the contrary, there were only expressions of support for the exemption. Furthermore, the unfairness of applying the approach of the House bill to life insurance companies but not to other taxpayers was criticized by Committee members, *e.g., Senate Hearings* 45, 48, 58, 411, and no satisfactory answer was given by the Treasury Department.

In addition to concern over the economic effect of the House bill, the constitutional validity of the add-back provisions was questioned at the very outset of the hearings when Senator Butler asked the Assistant to the Secretary of the Treasury, Mr. David A. Lindsay, whether these provisions would be invalid under the Constitution as interpreted by two decisions of the Supreme Court, obviously referring to *National Life* and *Gehner*. Mr. Lindsay's reply was: "I think this question might very well be litigated." *Senate Hearings* 43-44. Senator Butler then made the following statement:

> "[The bill] should not be tailored so as to embody doubtful legal provisions. . . .
>
> "I feel, as I have said, that the Supreme Court has been critical of this Congress for legislating in areas such as this. In addition we cannot rely upon

> the Supreme Court of the United States reversing two previous decisions on this point, and I feel that the Treasury should give this serious consideration." *Senate Hearings* 44.

Senator Talmadge also expressed concern with the constitutional question and asked Mr. Lindsay to look into the matter in more detail. *Senate Hearings* 48. The Treasury Department then submitted a memorandum which in a brief discussion of *National Life* stated that the statute involved in that case was "different" from the House bill and suggested that the trend of more recent decisions "casts considerable doubt on the constitutional aspects of the *National Life* case". *Senate Hearings* 50-51. No other decisions were cited, and the *Gehner* case was not even mentioned.

Subsequently Senator Butler inserted in the record of the hearings two memoranda in which both the *National Life* and *Gehner* cases were discussed at length, and the conclusion was expressed that the add-back provisions of the House bill could not be sustained under those decisions.[13] *Senate Hearings* 516-18, 700-2. One of these memoranda also stated:

> "Despite more recent decisions on collateral questions, these decisions remain unmodified and unchallenged. As such, they are the only appropriate guideposts in considering this vital question of constitutionality." *Senate Hearings* 701.

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[13] After quoting from the opinion in *National Life*, Senator Butler stated:

> "Note specifically that as in the National Life Insurance Company case the Treasury Department advocates that a so-called deduction allowed to a general class of taxpayers be diminished solely because of the receipt of interest from tax exempt securities." *Senate Hearings* 518.

Numerous other memoranda submitted by witnesses and interested parties repeatedly asserted that the method of taxation adopted in the House bill could not be reconciled with the constitutional immunity required by *National Life*, and that the method of allocation held invalid in *Gehner* on the authority of *National Life* was indistinguishable. *E.g., Senate Hearings* 305, 309, 311-12, 318, 407-8, 614, 632. Senators Byrd and Kerr expressed particular interest in the statement submitted by Mr. Harold J. Cummings, the President of Minnesota Mutual Life Insurance Company, one of the most comprehensive statements on this subject which, after a thorough analysis of the issues, concluded that the House bill "plainly proposes to contravene" *National Life* and that *National Life* "has never been repealed or qualified. It is the law of the land." *Senate Hearings* 308, 414 referring to the statement at 308-322. (This occurred after the exchange between Senator Kerr and Mr. Henry S. Beers to which petitioner refers at P. Br. 73-74.) There is nothing to support petitioner's claim (P. Br. 65) that most members of the Committee "apparently agreed" with the Treasury Department's viewpoint. Indeed, the record of the hearings discloses only expressions of concern by Committee members, a concern which was not that of Senator Butler alone. *E.g., Senate Hearings* 48 (Senator Talmadge), 58 (Senator Hartke), 59 (Senator McCarthy), 308 (Senator Byrd), 411 (Senator Talmadge), 414 (Senator Kerr), 420 (Senator Carlson).

The Senate Finance Committee redrafted the House bill, changing the reserve deduction to an exclusion for the "policyholders' share" and against the foregoing background it added the adjustment clauses. The report of the Senate Finance Committee recommended the division of investment income between the "policyholders' share" and the "company's share" as a "better concept" and it stated that a deduction was allowed for the tax-exempt interest included in the "company's share". The report went on to say that the committee had "added" the adjustment clauses, no doubt after the other changes had been made, and referring to these clauses the report stated that "in no case is any tax to be imposed on tax-exempt interest, on the thirty fifty-seconds of partially tax-exempt interest, or on the 85 percent of the dividends received." S. Rep. No. 291, 86th Cong., 1st Sess. 6, 17, 18 (1959). Thus the adjustment clauses assured not only that there would be no imposition of tax on state and municipal bond interest, but also that there would be no dilution of the exemption from normal tax provided for certain United States government obligations or of the inter-corporate dividends received deduction by reason of the revised method of taxing life insurance companies proposed by the committee.

Anyone familiar with the controversy that had developed at the hearings only two months earlier, regardless of whether he believed he fully comprehended the operation of the complex formulae contained in the bill as redrafted, could only have concluded from

this and other similar statements in the report,[14] excerpts from which were printed in the record of the Senate debates (105 Cong. Rec. 8402-8406), that the traditional immunity of state and municipal bonds would not be changed in any event, even if adjustments had to be made to accomplish this. When it was realized that there were doubts as to whether the basic exemption of state and municipal bonds was being provided, affirmative steps were taken to make sure there would be no deviation from the policy of complete exemption followed in all tax laws since the decision in *National Life*.

The same theme was repeated throughout the subsequent debates in both Houses of Congress, and, with the sole exception of Senator Curtis' statement quoted in petitioner's brief (p. 68), the adjustment clauses were mentioned each time it was said that state and municipal bond interest would not be taxed. Senator Curtis, a non-senior member of the Republican minority who could hardly have been regarded as the "spokesman" for the Committee (P. Br. 65, 67), indicated that he thought the deduction for the tax-exempt interest included in the "company's share" was adequate to

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[14] *E.g.*,

"The purpose of your committee in providing this treatment is to exempt a life insurance company from tax on any tax-exempt interest . . . . To give further assurance that no tax is to be imposed on tax-exempt interest . . . , your committee has added a special paragraph to the bill providing that if the application of the definition of taxable investment income does result in the imposition of tax on tax-exempt interest, . . . adjustment is to be made to the extent necessary to prevent any such imposition." S. Rep. No. 291, *supra*, at 17.

See also *id.* at 2, 19, 24.

assure the exemption. However, in his explanation of the operation of the bill he did not indicate that when tax-exempt interest was "allocated" to the "policyholders' share", a larger portion of the taxable items of investment income would be taxed to the company, and that the tax liability would thus increase or decrease as the amount of tax-exempt interest received increased or decreased. See 105 Cong. Rec. 8429.[15] It is evident that the other members of the Senate Finance Committee who voted to add the adjustment clauses had doubts about the operation of the bill despite this explanation.

Senator Byrd, who was the spokesman for the Senate Finance Committee and its chairman, in explaining the bill to the Senate stated without qualification that "it was the intention of the committee not to impose any tax on tax-exempt interest". After stating that the Treasury had assured the committee that the

[15] Senator Curtis gave the following example:

"Let us suppose that in a given year a company has $100 of tax-exempt interest income, and that it is determined that 70 percent of its investment income is needed to build up its life insurance reserves and annuity reserves to meet future claims of policyholders and beneficiaries. Under the bill, $70 of the $100 tax-exempt interest income would be allocated to policyholders reserves and the other $30 would be allocated to the company. Since no part of the policyholders reserves would become a part of the tax base, no part of the $70 tax-exempt interest allocated to those reserves would be taxed. Moreover, no part of the $30 allocated to the company would be taxed, because a deduction of the full $30 would be made in determining what part of the company's share of its investment income was to be subjected to tax.

"Thus, no tax-exempt income or credits of life insurance companies will be included in the tax base of such companies, under this bill. This should allay any fear that any constitutional provision is transgressed." 105 Cong. Rec. 8429.

bill did not impose any tax on tax-exempt interest,[16] he went on to say:

> "The bill adds a proviso to the effect that if the formula I have described does result in the imposition of a tax on this item, the formula is to be adjusted so that it does not do so." 105 Cong. Rec. 8401.

Thus the Senate was informed that although there were doubts as to whether full exemption was accorded to state and municipal bond interest under the formula, the adjustment clauses added by the Senate Finance Committee insured that the exemption would be preserved above all, even if changes had to be made in the formula to accomplish this. There is no basis for the assumption implicit in petitioner's argument (*cf.* P. Br. 76) that Congress would have passed the bill with the adjustment clauses omitted. The bill on which it voted contained the adjustment clauses and there is every basis for assuming that it would not have been passed without them.

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[16] The letter from the Treasury Department inserted in the record of the Senate debates, which did not indicate that the amount of the tax would be affected by the receipt of state and municipal interest, expressed the "opinion" "that the bill does not result in the imposition of any tax on the tax-exempt interest on State and municipal bonds." 105 Cong. Rec. 8402. If this was an opinion on the constitutional question, it was not responsive to the concern expressed in the Congressional debates as to whether the basic exemption would be provided for state and municipal bond interest. If it was an opinion that the policy of exemption traditionally followed by Congress would not be violated, it was simply wrong.

The telegram from the larger insurance companies approving the proration method of treating tax-exempt interest (105 Cong. Rec. 8402, quoted at P. Br. 74) is not indicative of Congress' purpose in enacting the adjustment clauses, which were not mentioned in the telegram, since these companies were more concerned with other issues than with the treatment of tax-exempt interest.

The changes in the bill made by the Senate were agreed to by the House in conference,[17] and the adjustment clauses remained in the bill although the Treasury Department may have attempted to have them removed at that point. In the final debates in both the House and the Senate on the bill with the adjustment clauses retained, the question of the taxation of state and municipal bond interest was again considered in a context which simply cannot be reconciled with petitioner's interpretation of the clauses. In the debate in the House, Congressman Mills, in answer to an inquiry expressing positive concern over the treatment of tax-exempt interest and inter-corporate dividends, said:

> "The pending bill clarified the language of the House bill to make it definite that we do not intend to tax the interest on tax-exempt securities. It provides that if it is established in any case that any provision of the bill results in levying a tax on tax-exempt securities such provision shall be adjusted so that it does not do so. This is a different approach from previous revenue acts passed since 1942 as the old laws were based upon the experience of the industry as a whole rather than on the experience of each individual company." 105 Cong. Rec. 10414.

In addition, Congressman Simpson said:

> "The treatment of tax-exempt interest under the conference version of the bill will make it more clear that such exempt income is not to be subject to tax." 105 Cong. Rec. 10413.

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[17] H. R. Rep. No. 520, 86th Cong., 1st Sess. 14-15, 16 (1959).

Senator Byrd, who explained the conference agreement to the Senate, stated:

> "I am glad to report to the Senate that the House conferees accepted the Senate amendment relating to tax-exempt interest. This amendment provided that if it is established in any case that the application of the definition of taxable investment income results in the imposition of the tax on any tax-exempt interest, . . . adjustment shall be made to prevent such imposition." 105 Cong. Rec. 10400.

Finally, in a revealing colloquy, Senator Thurmond inquired of Senator Byrd:

> "As I understand from the report, county and municipal bonds will not be taxed under the bill. Is that correct?"

Senator Byrd again referred to the adjustment clauses in his response:

> "That is my construction. There is a proviso that if by any chance under the bill they should be taxed, necessary steps will be taken to refund the tax."

Senator Thurmond thereupon remarked:

> "I was vitally interested in it. I believe it means a great deal to the people of our Nation to preserve our State municipal bonds untaxed by the Federal Government."

Senator Byrd agreed. 105 Cong. Rec. 10400.

No one could have understood these statements as meaning that state and municipal bond interest would

be accorded any different treatment under the bill than the complete exemption that Congress has long provided for all taxpayers, including life insurance companies. Surely the exemption which the Senate was told was being "preserved" would not permit the tax to be increased solely because of the receipt of state and municipal bond interest—a result which, apart from the provision held invalid in *National Life*, Congress has never provided for any taxpayer.[18] It is no "slander on the legislative process" (P. Br. 58) to give these statements the ordinary meaning which anyone hearing or reading them would understand. Every time state and municipal bond interest was mentioned, it was emphatically stated that no tax would be imposed on it, and the adjustment clauses were almost always referred to as assuring this. These repeated statements could not have been made if the adjustment clauses were intended, as petitioner attempts to interpret them, to operate like savings clauses which would apply only in the event that the tax imposed without adjustments was invalid under the Constitution. There was no suggestion that the tax would be imposed in a manner that could raise any question as to whether state and municipal bond interest was exempt.

While the Treasury and some members of the Congressional tax committees may have understood the

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[18] The fundamental difference to which Congressman Mills made specific reference, *supra* p. 27, between the 1959 Act and the 1942 Act, which did not have any effect on the individual company's receipt of tax-exempt interest, shows the fallacy of petitioner's assertion (P. Br. 12) that the two Acts were identical "in principle" with respect to the treatment of tax-exempt interest.

effect of the revised statutory formulae that were substituted in the Senate, the fact that these formulae would require a taxpayer with tax-exempt interest income to pay a higher tax than it would have had to pay had it not received such income was by no means "self-evident" or "plain and understood" by everyone (P. Br. 71, 73). The bill was a highly complicated one. Whatever may have been the understanding by the Treasury and some committee members, the fact is that there was no straightforward disclosure of this crucial point on the floor of either House when the many members of Congress who did not participate in the committee hearings were called upon to vote. It was not pointed out that the conceptual change in the allocation formula from a deduction to an exclusion was a change without economic difference, except possibly for an implication in the general statement made by Congressman Mills in the House quoted at P. Br. 70. At no point, even in response to specific questions, was it ever stated on the floor of either House that the effect of the bill without the adjustment clauses would be to increase a life insurance company's tax liability solely because of its receipt of state and municipal bond interest. Surely if this result was as "self-evident", "plain" and "understood" as petitioner says it was, the distinguished Congressmen who presented the matter on the floor of each House would have been impelled to point it out if they had not thought that the adjustment clauses negatived such a result, thereby making any reference to it unnecessary. Any other conclusion, we submit, is "utterly implausible".

II

Petitioner's Apportionment Argument Disregards the Traditional Immunity of State and Local Government Obligations From Federal Income Taxation and Raises Constitutional Questions That This Court Should Avoid.

Petitioner's entire argument is based on the premise that no tax is imposed on state and municipal bond interest if the statutory scheme provides a "fair" apportionment of deductions between classes of income. In petitioner's view the question to be considered "is not whether the tax is more, but whether the . . . apportionment is reasonable". (P. Br. 29) If a deduction is disallowed on account of a reasonable apportionment, the inquiry ends because the taxpayer has been treated "fairly". Throughout its brief, petitioner neglects the fact that the constitutional immunity with which Congress was concerned is one designed to protect state and local governments. Nowhere does petitioner make any attempt to establish that the method of apportionment applied by it will not have an adverse economic effect on state and local governments. Nowhere does petitioner consider the effect on the state and local governments because "the tax is more".

Petitioner's attempt to justify an "allocation" of the reserve deduction to tax-exempt interest on the ground that such allocation is "fair" misconceives the nature of the exemption of state and municipal bond interest from Federal taxation. It is not enough that an "allocation" be "fair" in the sense that it does not discriminate against the receipt of tax-exempt interest.

If this were the test of immunity, state and municipal bond interest could always be taxed. Under our Federal statutes and Constitution, the obligations of state and local governments are given a preferred position in order not to impair the borrowing power of the States. See *Helvering* v. *Gerhardt*, 304 U. S. 405, 417 (1938); *Hale* v. *Iowa State Board*, 302 U. S. 95, 107 (1937); *Pollock* v. *Farmer's Loan & Trust Co.*, 158 U. S. 601, 630 (1895). Because of this preferred position, no tax, not even a non-discriminatory one, may be imposed on state and municipal bond interest by the Federal government.

Because of the exemption of state and municipal bond interest from Federal income taxation, the market places a premium on state and municipal bonds and permits such obligations to be sold at a lower yield than corporate obligations of similar grade. By investing in state and municipal bonds, life insurance companies and other investors forego the higher yield that could be obtained from taxable securities. Thus, the real beneficiary of the exemption of state and municipal bond interest from Federal income taxation is not the life insurance company that invests in such bonds but the state and local governments that issue the obligations purchased by the company. In resisting the various attempts of the Treasury Department to limit the state and municipal bond exemption, Congress has recognized this. If deductions may be allocated in the manner suggested by petitioner, it can only operate to the detriment of the state and local governments. Life insurance companies could not afford the reduction in yield without the full benefit of the immunity.

Under petitioner's argument, the sole explanation for the adjustment clauses is the prevention of litigation on the question of whether state and municipal bond interest may be taxed by the Federal government under the Constitution but, inconsistently, petitioner argues that the clauses apply only in the event that it is first found that the statutory formulae violate what petitioner characterizes (*e.g.*, P. Br. 35) as the "assumed" constitutional prohibition against imposing a tax on interest from state and municipal bonds. Of course, since it is petitioner's contention that the statutory formulae do not do this, the adjustment clauses are a mere appendix to the statute, which need be given no substantive meaning.

Petitioner's contention that the function of Sections 804(a)(6) and 809(b)(4) is to provide an adjustment only if the statutory formula "violates the assumed constitutional prohibition against a tax on interest from state bonds" (P. Br. 62) would of course raise the very constitutional questions which Congress intended to avoid. The determination whether the operation of the formula "violates the assumed constitutional prohibition" is itself constitutional litigation which if relevant would require a thorough examination by the Court of the scope and purpose of the immunity from taxation of state and local bonds. The life insurance company taxing formula obviously cannot be tested against an "assumed" constitutional standard without full discussion of the standard to be applied and without full knowledge of the economic and other effects of applying the standard.

As a matter of sound judicial policy, this Court does not consider constitutional questions where such ques-

tions may be avoided. And where a case may be decided on either of two grounds, one involving a constitutional question, the other a question of statutory construction, this Court will decide only the latter. *Ashwander* v. *Tennessee Valley Authority*, 297 U. S. 288, 347 (1936); *Rosenberg* v. *Fleuti*, 374 U. S. 449, 451 (1963). As Chief Justice Hughes said in *Crowell* v. *Benson*, 285 U. S. 22, 62 (1932), "... it is a cardinal principle that this Court will first ascertain whether a construction of the statute is fairly possible by which the [constitutional] question may be avoided.". The importance of applying this policy is particularly present where the constitutional area involved is the sensitive area of inter-governmental tax immunities involving the relationship of state and local governments to the Federal government. Certainly, this Court should reject an interpretation of the statute which would narrow the traditional immunity and raise a constitutional question, particularly where the question has not been fully canvassed by the lower courts, and the record does not show the economic and other effects of such action on state and local governments. Petitioner has presented no evidence which would justify this Court's narrowing the immunity and reaching the constitutional question Congress intended to avoid. The traditional immunity can only be preserved if *National Life* is followed and Sections 804(a)(6) and 809(b)(4) are given substantive meaning.

A. The *National Life* Decision Must Be Followed.

No one, we submit, can read the decisions of this Court in the *National Life*, *Gehner* and *Slayton* cases without concluding that the Court intended in those

cases to establish that the constitutional immunity of interest on state and municipal bonds from taxation would be violated by the imposition of a greater tax on one's taxable income, through disallowance of deductions not directly attributable to the earning of tax-exempt income, solely because he received tax-exempt income. While petitioner says that the function of the adjustment clauses is to provide for adjustments only if the statutory formulae cannot be applied consistently with "the established constitutional immunity" from taxation of interest on state and municipal bonds (P. Br. 53), yet in effect it argues that the doctrine established by these cases should be disestablished and a new one substituted. Thus, according to petitioner, in legislating with a view toward the established doctrine in this area Congress meant not the existing doctrine established by these unreversed decisions but a "living growing body of principles" (P. Br. 59) that might hopefully be developed in this or some future litigation. This interpretation cannot be sustained.

In *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), where the statute expressly referred to the Constitution as the standard, the Commissioner of Internal Revenue argued that the decision in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), should not be followed because of subsequent cases just as petitioner in its brief (pp. 59-60, 61-62) seems to suggest that "existing law" might be different than *National Life*.

Griffiths is much closer to the present case than petitioner recognizes in its brief, as an examination of the legislative history considered by the Court in *Griffiths*

discloses. The question of the constitutional validity of *Macomber* was squarely faced by Congress when the Revenue Bill of 1936 was before it in connection with a proposal to tax the shareholders of corporations on the undistributed earnings of the corporation. 318 U. S. at 376-77 & nn.8-12. It was the discussion of this proposal, which was abandoned because of doubts that it would be constitutional, that the Court referred to as indicating that Congress had no intention "to challenge or override" the *Macomber* decision. 318 U. S. at 378. Similarly, during the same session of Congress that enacted the Life Insurance Company Income Tax Act of 1959, the question of Congress' power to tax income from state and municipal bonds in view of *National Life* and other decisions was the subject of extensive studies and discussions in Congress. See Compendium of Papers on Broadening the Tax Base Submitted to the House Ways and Means Committee, 86th Cong., 1st Sess. 679-791 (1959); Panel Discussions on Revision of the Federal Income Tax Structure Before the House Ways and Means Committee, 86th Cong., 1st Sess. 339-402 (1959). Congress took no action in 1959 to repeal the statutory exemption of such interest, consistent with its reaction to numerous similar proposals in prior years.[19]

In *Griffiths* the Court held that the question of the constitutional validity of *Macomber* could not be reached since Congress had not intended to legislate

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[19] The history of these proposals is summarized in Compendium of Papers on Broadening the Tax Base Submitted to the House Ways and Means Committee, 86th Cong., 1st Sess. at 680-81, 702-4 (1959).

contrary to *Macomber*. In an opinion by Mr. Justice Jackson, the Court recognized that this question was "plainly one of the first magnitude", but then it said:

> "Under our judicial tradition, we do not decide whether a tax may constitutionally be laid until we find that Congress has laid it. Unless the tax asserted by the Commissio' has been authorized by Congress, it fails of va..dity before we even reach the constitutional question." 318 U. S. at 394.

After examining the legislative history in detail, Justice Jackson found no indication that Congress intended to act contrary to the *Macomber* decision, saying:

> "We think if Congress had passed or intended to pass an Act challenging a well known constitutional decision of this Court there would appear at least one clear statement of that purpose either from its proponents or its adversaries. Not one contemporaneous word in or out of Congress discloses the purpose which the Government says we should find that this legislation accomplished." 318 U. S. at 389.

The petitioner argued in *Griffiths*, somewhat as it does here, that the peculiar form of the statute was attributable to "embarrassment" which would have been incident to a "frontal attack" on *Eisner* v. *Macomber*. The Court refused, however, to speculate on the motives which may have led Congress to the choice employed in the language of the statute, stating that such speculation "has no place in the construction

of Acts of Congress".[20] 318 U. S. at 402. The Court also said:

> "We would be reluctant, in any event, to find that Congress intended to hold the effect of § 115(f)(1) in abeyance until the Treasury should decide that the time was ripe to challenge *Eisner* v. *Macomber* and carry its challenge to this Court. Such an intention would be a serious departure from the usual policy of Congress to provide the taxpayers and tax-gatherers with a practical basis for the timely settlement of questions of taxation arising each year." 318 U. S. at 399.[21]

Petitioner's interpretation of the adjustment clauses flies in the face of all the factors considered important in *Griffiths*. The Congress that enacted the Life Insurance Company Income Tax Act of 1959 clearly did not intend to challenge or override *National Life*. The repeated statements that no tax would be imposed on state and municipal bond interest made in the committee reports and the floor debates simply cannot be reconciled with any such intention, and the addition of provisions requiring adjustments in the taxing formula affirms that Congress intended above all to preserve that exemption of state and municipal bond interest. Those provisions obviously were not regarded

[20] In addition Justice Jackson noted that a literal reading of the statute, which used the word "does", led to the conclusion that Congress intended to determine taxability in terms of existing law, which at that time was found in the *Macomber* decision which had never been overruled. 318 U. S. at 394. In the present case, the statute uses the word "results" and existing law, as Congress was well aware, is to be found in *National Life*.

[21] A similar argument, characterized by the Court as "startling", was rejected in *Sinclair Ref. Co.* v. *Atkinson*, 370 U. S. 195, 209-10 (1962).

by Congress as only a "caveat"; they plainly constitute exceptions, and they affirmatively negate any "wanting" by Congress to increase the tax because of the taxpayer's receipt of state and municipal bond interest (P. Br. 61-62). The record of the legislative history does not contain a single statement indicating there would be any change in the nature of the exemption, least of all a change so fundamental as that which petitioner asks for here. And the reasons suggested by petitioner for the enactment of the adjustment clauses and its interpretation of the language of those clauses imputes to Congress the same motives which the Court in *Griffiths* refused to accept or even inquire into. As in *Griffiths,* there is no occasion for this Court to reexamine *National Life* since Congress plainly did not intend to impose a tax which would be invalid under the rationale of that decision.

Furthermore, petitioner's attempt to distinguish *National Life* because of differences in the amount of the reduction involved in that case cannot withstand analysis. The Court did not hold, as petitioner implies (P. Br. 37), that the deduction of all exempt interest from the reserve deduction, instead of only a "pro rata" portion, was the vice of the 1921 Act. In its discussion of *Packard Motor Car Co.* v. *City of Detroit,* 232 Mich. 245, 205 N. W. 106 (1925), the Court recognized that such an "allocation" of deductions on account of tax-exempt bonds had been employed, and it summarized approvingly the holding in *Packard* as follows:

> "... tax exempt credits may not be taxed, directly or indirectly, and in levying a tax on property

they must be treated as nonexistent." 277 U. S. at 521.[22]

The *National Life* opinion also referred with approval to *Northwestern Mut. Life Ins. Co.* v. *Wisconsin*, 275 U. S. 136 (1927), and *Miller* v. *Milwaukee*, 272 U. S. 713 (1927), both cases involving the incidence of a state tax on obligations of the Federal government,[23] to illustrate the principle of immunity. These cases, like *Packard*, make it clear that the Court in *National Life* was requiring that state and municipal

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[22] In *Packard*, the Supreme Court of Michigan said:

"Tax exempt credits cannot be taxed, directly or indirectly. In laying a tax on property, tax exempt credits must be treated as nonexistent. The legislature may not make use of, or permit consideration to be taken of tax exempt credits as a factor in determining taxes to be paid by holders thereof. To do so would attach a condition to the enjoyment thereof wholly incompatible with the issuance thereof and impair the underlying contract." 232 Mich. at 247-48, 205 N. W. at 107.

[23] The *Northwestern* case considered a Wisconsin statute, which imposed a license fee on insurance companies at the rate of 3 per cent of gross income. Northwestern claimed that income from United States bonds could not be included in the computation of the tax. The state maintained that the tax was imposed on the privilege of doing business in the state, not on United States bonds. The Court held that the tax was nevertheless an imposition on the bonds, saying:

"[I]f the challenged Act, whatever called, really imposes a direct charge upon interest derived from United States bonds, it is *pro tanto* void." 275 U. S. at 140.

The *Miller* case considered a Wisconsin income tax statute which provided that all dividends were taxable income, but allowed a deduction for dividends received from corporations which themselves were subject to the Wisconsin income tax. The statute provided that where only part of the income of a corporation had been taxed, only a corresponding part of the dividend was deductible by the stockholders. The dividends in question came from corporations which owned United States bonds, the interest on which was exempt from tax at the corporate level; because of the exemption, the dividends were not fully deductible by the stockholders. The Court held that, although dividends to stockholders are not generally identi-

bond interest be treated as if it had not been received in calculating the tax on income which is taxable. Petitioner's statement that "there is nothing in *National Life* inconsistent with [petitioner's] position in the present case" (P. Br. 38) is legal nonsense.

The application of *National Life* to the "allocation" of deductions is made all the more clear by *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930), which followed *National Life* in holding invalid an allocation formula which cannot be distinguished from the formula petitioner advocates here. Chief Justice Hughes separately concurred in *Gehner* "on the ground that this case is governed by *National Life Ins. Co.* v. *United States*, 277 U. S. 508." 281 U. S. 322. And the opinion in *Gehner* shows that none of the grounds on which petitioner attempts to distinguish *National Life* is of any substance.

Gehner cannot be distinguished on the ground that a state property tax was involved, for it uses the *National Life* case as a controlling precedent, and many of the cases cited in *National Life* involved the immunity of Federal obligations from state taxation. Both *National Life* and *Gehner* recognized the interchangeability of the principles applicable to the exemp-

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fied with the corporate funds from which they are paid, it was necessary to do so in this case in order to protect the exemption of United States bonds. It said:

> "If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or special operation it would be perfectly good." 272 U. S. at 715.

It held that tax was imposed on United States bond interest by reducing the stockholders' dividend deduction because of the United States bond interest received by the corporation, and that such tax was invalid.

tion of state and municipal bonds from taxation by the Federal government and the exemption of United States obligations from taxation by the states. And the *Gehner* opinion (quoted *supra* at p. 13) cited the *Northwestern* and *Miller* cases alongside *National Life*. These cases did not involve a property tax; the tax in *Northwestern* was a license fee measured by gross income, and the tax in *Miller* was a state income tax. Thus the exemption required in *National Life* and *Gehner* is identical: The ownership of exempt property or income may not be made the basis of diminishing a deduction which would be allowed if the taxpayer owned no such property or income.

Petitioner's claim that *Gehner* is different because Congress has enacted a statute exempting Federal obligations from state taxation overlooks the fact that Congress has consistently provided by statute the same exemption for state and municipal bond interest from Federal income taxes. The Congressional policy of complete exemption is applicable to both state taxation of Federal obligations and Federal taxation of state obligations.[24]

The Congress that enacted the Life Insurance Company Income Tax Act of 1959 took action to ensure

[24] The reason for the exemption of state and municipal bond interest in the corporate excise tax enacted as part of the Tariff Act of 1913, the first modern income tax law passed by Congress, was explained by Congressman Cordell Hull as follows:

> "The Supreme Court has often held that under our form of government the States have no power to tax the instrumentalities of the Federal Government and conversely that the Federal Government has no power under the Constitution to tax the instrumentalities of the States; not desiring to raise any constitutional question, or to arouse the antagonism of any of the States, this provision was inserted." 50 Cong. Rec. 508.

that income from Federal obligations would be excluded from gross income in computing state taxes on net income thus providing the same exemption as that provided state and municipal bond interest under the Federal income tax laws. Pub. L. No. 86-346, 73 Stat. 622; S. Rep. No. 909, 86th Cong., 1st Sess. 8 (1959).[25] Even before this amendment this Court had recognized that arguments similar to those made by petitioner here violated the exemption which Congress intended to provide. In *New Jersey Realty Title Ins. Co.* v. *Division of Tax Appeals*, 338 U. S. 665 (1950), it was held that even if the intangible property tax involved in that case were viewed as being imposed only on taxable property, the exemption was violated where the rate of assessment on the taxable property increased from 15 percent to 79 percent solely because the ownership of

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[25] Section 3701 of the Revised Statutes of the United States, now 31 U. S. C. § 742 (Supp. IV, 1963), was amended to provide: "This exemption extends to exery form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. . . ." The Senate Finance Committee explained this amendment as follows:

> "Present law provides that obligations of the United States are to be exempt from taxation by or under State or local authority. The Supreme Court has held that this includes the exemption of interest on U. S. obligations from taxation by or under State or local authority. It has been pointed out to your committee, however, that one State has taken the position that the statute as now worded does not prohibit a State from including interest on Federal obligations in computing 'gross income' upon which taxable net income is determined. The bill (sec. 105) makes it clear that the exemption for Federal obligations extends to every form of taxation that would require either the obligation, or the interest on it, or both to be considered directly or indirectly in the computation of the tax, except nondiscriminatory franchise taxes (or other nondiscriminatory non-property taxes imposed in lieu thereof) on corporations and except estate or inheritance taxes." S. Rep. No. 909, 86th Cong., 1st Sess. 8 (1959).

Federal bonds was taken into account.[26] The rationale of the cases involving apportionment of net income under state taxing statutes which are cited by petitioner (P. Br. 14, 28, 43-44) simply has no application where an exemption statute is involved. However, the rationale of the *New Jersey Realty Title* case is applicable in the present case since the Congressional policy with respect to the exemption of state and municipal bonds from Federal taxation is identical. In light of this Congressional policy, petitioner's suggestion that the Federal exemption is of a higher order than the state exemption has no merit and furnishes no basis for analytical distinction.

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[26] In an opinion by Mr. Justice Clark, the Court said:

"If the assessment is considered to be 15 per cent of capital and surplus less liabilities or of entire net worth, we agree with the court below that the tax levied under § 54:4-22 does not impose a discriminatory burden on federal issues as did the tax statute against which § 3701 was invoked in *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930). But since the decision in *Bank of Commerce* v. *New York City, supra* [67 U. S. 620 (1863)], it has been understood that a tax on corporate capital measured by federal securities may be invalid even though imposed without discrimination against federal obligations.

"If, however, the assessment of $75,700 is viewed as if it were levied exclusively upon appellant's net worth remaining after deduction of government bonds and interest, the assessment would be discriminatory since it would be levied at the rate of over 79 per cent of appellant's assessable valuation of $94,936.87 rather than at the rate of 15 per cent prescribed by § 54:4-22. Such increased rate of assessment would result solely from appellant's ownership of federal issues. In the *Gehner* case, *supra*, this Court held that § 3701 was offended by a computation which allowed deduction of the full amount of the taxpayer's federal bonds yet at the same time pared down the net value of other allowable exemptions, to the taxpayer's disadvantage, solely because of such ownership of federal bonds. Consistently with the *Gehner* decision, we can only hold that § 3701 is violated by an automatic increase in the rate of assessment applied to appellant's valuation after deduction of federal bonds." 338 U. S. at 674-75.

B. Petitioner's Concept of the Immunity of State and Municipal Bond Interest From Federal Income Taxation Is Not Supported by the Authorities and Examples Cited in Its Brief.

Denman v. *Slayton*, 282 U. S. 514 (1931), and *Helvering* v. *Independent Life Ins. Co.*, 292 U. S. 371 (1934), do not support petitioner. Neither case was cited or referred to in the memorandum submitted by the Treasury Department to the Senate Finance Committee during the hearings or in the Congressional debates on the Act herein involved. Neither case contains the broad holding which petitioner suggests, and both reaffirm the holding in *National Life*.

The expenses for which deductions were denied in *Denman* v. *Slayton* were incurred for the purpose of purchasing tax-exempt securities. The Court recognized that this was "radically different" from *National Life*, where the expenses denied deduction would have been incurred regardless of the receipt of exempt income.[27]

The Court described Slayton's position as follows:

> "Under the theory of the respondent, 'A,' with an income of $10,000 arising from non-exempt securities, by the simple expedient of purchasing exempt ones with borrowed funds and paying

[27] The Court said:

"The circumstances disclosed in *National Life Ins. Co.* v. *United States* were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of § 245(a), Revenue Act 1921, 42 Stat. 227, 261." 282 U. S. at 519.

> $10,000 interest thereon, would escape all taxation upon receipts from both sources. It was proper to make provision to prevent such a possibility." 282 U. S. at 519-20.

It is clearly consistent with *National Life* to exclude the $10,000 of interest expense along with the income from the tax-exempt securities. Otherwise a taxpayer could obtain undue tax benefits by purchasing tax-exempt securities with borrowed money.[28] Petitioner's argument here goes much further. It would deny deductions not only for the interest incurred to purchase the exempt securities, but for other expenses to which income from the exempt securities is "allocated" or "apportioned", even though those expenses would have been incurred in any event and would have been fully deductible if no exempt income had been received.

The annual increase in a life insurance company's reserve liabilities to provide for policyholders' claims occurs whether or not the company has taxable investment income, tax-exempt income or any income at all. As such it is an expense of doing business which must be satisfied before there can be any income to be taxed. To disallow a deduction for such an expense because of the receipt of tax-exempt interest would be a radical departure from the policy of exemption long followed by Congress and the courts. The real meaning of the exemption of state and munic-

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[28] In discussing the illustration at pages 25-6 of its brief, petitioner misconceives respondent's position. Since the interest on the funds borrowed by A to purchase tax exempt bonds would be excluded from the tax computation along with the tax exempt interest in keeping with *Denman v. Slayton*, A's tax would be neither higher nor lower than if it had not bought the tax exempt bonds.

ipal bond interest would be lost, for the economic effect of the denial of deductions is the same as including such interest in gross income. When one such proposal was made in connection with the Revenue Bill of 1924, it was described on the floor of the Senate, where it was rejected, as follows:

> "To say in one breath that a security shall remain untaxed, and in the next breath that deductions shall be allowed on general taxation, but that if a citizen shall hold tax-exempt securities the extent of the reduction shall be diminished by the interest on the obligations of the Government which he holds, is only another way of saying that a tax shall be levied upon these securities." 65 Cong. Rec. 7668 (1924).[29]

Except for the provision of the 1921 Act held invalid in *National Life,* Congress has not taken nor has this Court sanctioned the step which petitioner asks the Court to impute to Congress in this case.

Helvering v. *Independent Life Ins. Co.,* 292 U. S. 371 (1934), a case which involved no question as to the exemption of state and municipal bond interest, applied the same principal as *Denman* v. *Slayton,* and, far from limiting *National Life,* the Court recognized that the problem dealt with in *National Life* was completely different. The Court noted that the only effect

[29] The Revenue Bill of 1926 as passed by the House of Representatives contained a provision like that rejected in 1924 which would have denied deductions for interest not incurred in a trade or business to the extent that the taxpayer received tax-exempt interest income. When this was stricken out by the Senate Finance Committee, the committee commented: "The indirect effect was to impose a tax upon interest which otherwise would be exempt." S. Rep. No. 52, 69th Cong., 1st Sess. 21 (1926).

of the statute in *Independent Life* was to deny deductions for depreciation, taxes and other expenses relating to space occupied by the company in a building owned by it and partly rented to others. At that time such expenses were not deductible by life insurance companies. Only income from investments was taxed, and accordingly only investment expenses were deductible.[30] Since there was no denial of deductions relating to the portion of the building that was rented and which produced rental income, the Court recognized that *Slayton* was applicable and that there was no issue like that in *National Life*. In an opinion by the same Justice who wrote for the Court in *Gehner*, the Court said:

> "Respondent cites *National Life Ins. Co.* v. *United States*, 277 U. S. 508, but the distinction between that case and this one is fundamental and obvious. There the effect of the statutory deduction was to impose a direct tax on the income of exempt securities, amounting to the taxation of the securities themselves . . . In *Denman v. Slayton*, 282 U. S. 514, we held the taxpayer not entitled to deduct the interest on debts incurred to purchase securities the interest on which was exempt. The opinion points out the distinction between that exclusion from deductions and the taxation of exempt securities . . .", 292 U. S. at 381.

Petitioner's example (P. Br. 24-25) of the allocation of automobile expenses between business and personal uses is, like *Independent Life*, only a matter of identifying expenses which are directly attributable

[30] The result is not the same under the present Act, since expenses not allowed as deductions from investment income under Section 804 (c)(3) are deductible under Section 809(d)(12) in computing gain from operations. Petitioner overlooks this at P. Br. 42 n.13.

to more than one use. The portion of the automobile expenses allocated to business use is reduced only if and because the automobile is not actually used for business purposes. It is not reduced if or because the owner of the automobile happens to own some state and municipal bonds from which he receives tax-exempt income, or because he happens to own his own home the rental value of which is not taxed to him as income. Petitioner's failure to recognize this difference between the allocation of expenses which may or may not be deductible depending on how they are identified, which is all there is to its examples at P. Br. 23-24 and 25-26, and the denial of deductions for expenses that are incurred in any event and are denied only because of the receipt of state and municipal bond interest—which is not really "allocation" at all[31]—is the fundamental defect in its whole argument.

Petitioner's discussion of the taxation of trusts (P. Br. 26-27, 30-31) is no more analogous than its automobile expense example, for life insurance companies are not conduits for their policyholders under either state law or Federal tax law. Their reserves reflect liabilities under insurance contracts which are claims against all their assets, and such liabilities increase annually regardless of the nature or amount of income received by them. There is no "fund", nothing is

[31] Petitioner ignores the fact that under the statutory formula all investment expenses are first substracted before there is any "allocation" of investment income between the "policyholders' share" and the "company's share". See Section 804(c). The only true allocation is the assignment of general expenses between investment income and other income as prescribed in Treas. Reg. § 1.804-4(b)(1)(ii).

"set aside" (P. Br. 5), and annual increases in reserve liabilities cannot be identified with actual earnings in any meaningful sense.

The income of life insurance companies is not received in any "dual capacity" (P. Br. 49), for whether the income is from tax-exempt state and municipal bonds, taxable corporate bonds, corporate dividends or any other source affects only the companies. They and they alone are affected by the lower interest rates that state and municipal bonds customarily bear, and if the yield on such bonds is less than the rate at which reserve liabilities increase, it is their responsibility to make up the difference. Thus, cases like *Burnet* v. *Wells*, 289 U. S. 670 (1933); *Reinecke* v. *Smith*, 289 U. S. 172 (1933); and *Corliss* v. *Bowers*, 281 U. S. 376 (1930), holding that the ownership of income may be attributed to the person receiving the economic benefit of it, do not support petitioner's argument in this case.

The statutory description in the Life Insurance Company Income Tax Act of 1959 of a portion of an insurance company's investment income as the "policyholders' share" in order to provide the equivalent of a deduction in respect of increases in reserve liabilities does not take away any rights of the insurance company or confer any upon the policyholders. The policyholders are not taxed on the company's earnings—a result suggested by petitioner's argument which Congress and the Treasury surely did not intend.[32]

[32] The full amount of tax-exempt interest is treated as belonging to the company in the computation of the "phase 3" tax base, despite the "allocation" to the policyholders' share in phases 1 and 2. See Section 815(b)(2)(A)(iii); Treas. Reg. § 1.815-3(d).

Life insurance companies, like corporations generally, are single taxpaying units. No question of allocating income between two or more taxpayers is involved as in the case of trusts. Even regulated investment companies and real estate investment trusts, the only corporate taxpayers given any form of "conduit" treatment under the tax laws, are not permitted to treat their earnings distributed to shareholders as consisting of any earmarked tax-exempt income that the company or trust may receive as such.[33]

C. Petitioner's Interpretation of Sections 804(a)(6) and 809(b)(4) Is Contrary to the Language of Those Sections.

The language of Sections 804(a)(6) and 809(b)(4) by itself negates petitioner's attempt to interpret them as intended only to "forestall" a challenge to the "established" constitutional tax immunity of state and municipal bond interest in the event of a determination that the formula otherwise would result in the imposition of tax on such interest (P. Br. 75-76). In each of these sections, subdivision (B) applies to interest on certain obligations of the United States which interest is exempt from normal taxes under the act authorizing such obligations (see Section 242), and subdivision (C) applies to dividends received from other corporations for which certain deductions are allowed under Sections 243-245. Obviously, the partial Federal tax exemption of obligations issued by the Federal government has no relation to the constitutional problem of Federal taxa-

[33] See Compendium of Papers on Broadening the Tax Base Submitted to the House Ways and Means Committee, 86th Cong., 1st Sess. 1658-70 (1959).

tion of interest on state and municipal bonds, nor does the power of Congress to limit or even deny completely the deduction or partial exemption for intercorporate dividends, which would not seem to raise a constitutional problem at all.

Petitioner's additional claim (P. Br. 12, 20-24) that income must, by a process of "allocation", be matched with deductions before it can be determined whether there is a "tax on" state and municipal bond interest within the meaning of the adjustment clauses ignores the fact that the exemption of state and municipal bond interest provided throughout the history of the Federal income tax has been an exclusion from gross income. The only reasonable reading of the adjustment clauses, which refer to a "tax on . . . any interest which under Section 103 is excluded from gross income. . . .", is that Congress intended for life insurance companies to have the same exemption. Petitioner's semantic argument focusing on the words "tax on" by themselves is simply beside the point here where the exemption being protected is an exclusion from gross income.

Respondents' tax liability, as determined by petitioner, is increased solely because state and municipal bond interest is included in "gross investment income".[34] It is this increase that the adjustment clauses are designed to eliminate.

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[34] In terms of the definitions contained in the statute, "investment yield" is "gross investment income" less certain deductions connected with investment income. Section 804(c). State and municipal bond interest is included in "gross investment income" (see Treas. Reg. § 1.804-3(a)(1)(i)), and thus it increases "investment yield". Each item of "investment yield" is then divided between the "policyholders' share" exclusion and the amount taxed to the company as the "company's share". The division is made on the basis of percentages

Where the adjustment clauses apply, the basic exemption of state and municipal bond interest afforded to other taxpayers under Section 103 is preserved for life insurance companies by excluding such interest from gross income throughout the tax computation, as the Court of Appeals directed.[35] Thus state and municipal bond interest was excluded both from "investment yield" in arriving at the percentage of investment income taxed to the company as the "company's share" and from the computation of the earnings rates used in arriving at "policy and other contract liability requirements" under phase 1, the only other place where such interest entered into the tax computation.[36]

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arrived at by dividing "investment yield" into "policy and other contract liability requirements" in phase 1 and "required interest" in phase 2. Sections 804(a)(1), 809(a)(1). Since the latter amounts remain relatively fixed, the increase in "investment yield" resulting from the inclusion of state and municipal bond interest decreases the percentage of investment income excluded as the "policyholders' share" and increases the amount taxed to the company as the "company's share". The percentage thus determined is applied to each and every item of investment income included in "investment yield" (§§ 804(a)(1), 809(a)(1)), and thus a larger portion of both the taxable and nontaxable items of income is included in the "company's share" as a result of this computation. The tax-exempt income included in the "company's share" is then deducted (§§ 804(a)(2)(A)(i), 809(d)(8)(A)(i)), but the increase in the amount of the taxable items of income taxed to the company is not removed in any subsequent steps in the computation, and unless the adjustment clauses are applied the increase is included in "taxable investment income" and "gain from operations" and the ultimate amount of the tax is increased.

[35] A comparative analysis of the computation of the tax collected from respondent and of the tax computed with the adjustments ordered by the Court of Appeals is set forth in Appendix B at pp. 64-76.

[36] The "policyholders' share" exclusion under phase 1 is equal to "policy and other contract liability requirements", as defined in Section 805. Under that section, reserve liabilities are recomputed pursuant to an actuarial formula designed to restate the reserves as they

The exclusion of such interest from earnings rates had the effect of reducing the amount excluded as the "policyholders' share" in phase 1. Thus, while 85.3364% of respondent's state and municipal bond interest, or $31,265.37, is "allocated" to the "policyholders' share" in petitioner's computation of "taxable investment income", the adjustment ordered by the Court of Appeals reduced the "policyholders' share" and hence respondent's "taxable investment income" by only $11,258.64. The remaining $20,006.73 is the decrease in "policy and other contract liability requirements" resulting from the lower earnings rates with state and municipal bond interest excluded. Thus the adjustments did not have the effect described by petitioner (P. Br. 10) of "allocating" all such inter-

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would appear if they had been built upon the basis of the company's actual earnings experience instead of assumed interest rates. The recomputed reserves, called "adjusted life insurance reserves", are then multiplied by the "adjusted reserves rate", which is the lower of the earnings rate for the current year or the average of the earnings rates for the current year and the preceding four years. Thus the reduction in earnings rates resulting from the exclusion of state and municipal bond interest from their computation lowers the amount determined to be "policy and other contract liability requirements".

The bonds themselves were not excluded from assets in determining earnings rates but were treated in effect as assets which produced no income, like idle bank accounts. Exclusion of such bonds from assets would have increased earnings rates, thereby conferring an undue benefit by reducing the tax on the taxable items of investment income. The adjustments ordered by the Court of Appeals are neutral with respect to investment in state and municipal bonds.

In phase 2 the "policyholders' share" exclusion is equal to "required interest", which is determined by multiplying the company's reserve liabilities by the interest rates assumed by the company in calculating increases in its reserve liabilities for state reporting purposes. "Required interest" is not affected by earnings.

est to the company and "allocating" only taxable items of income to the amount excluded or deducted as the "policyholders' share". On the contrary, it made the deduction for reserve liability increases neutral with respect to the receipt of interest on state and municipal bonds.

Sections 804(a)(6) and 809(b)(4) are exceptions, plainly labeled as such, which apply only where the tax would be increased as a result of the inclusion of state and municipal bond interest in gross income. If no increase in tax results, the exemption of state and municipal bond interest is not impaired by the inclusion of such interest in the tax computation. This may occur, for example, in the case of companies with a low ratio of reserves to assets and an investment yield of less than $250,000 for which the small business deduction equal to 10 percent of investment yield (§§ 804(a)(4), 809(d)(10)) may be larger than the increase in the taxable items of investment income taxed to them that results when the larger "investment yield" is used to determine the "policyholders' share" exclusion.[37] Thus the adjustment clauses do not apply in every case, as petitioner claims (P. Br. 57), and the result would not have been the same in all cases if Congress had eliminated tax-exempt interest from the formula altogether (*cf.* P. Br. 57).

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[37] See The National Underwriter, March 6, 1965, p. 22. The study reported in this article did not cover most of the smaller companies where this result would occur, although some instances were found among the companies that were studied.

Even if adjustments had to be made in every case where state and municipal bond interest is received, the statutory formula would not be rendered inoperative. The detailed provisions of the Life Insurance Company Income Tax Act of 1959 apply to all aspects of the taxation of life insurance companies. Congress did considerably more than devise a formula affecting only tax-exempt interest. It provided a basic change in the method of taxing life insurance companies, and this change is effective even if tax-exempt interest, which normally is a relatively small portion of a life insurance company's income,[38] is eliminated from the tax computation under the adjustment clauses. The sole purpose in enacting the adjustment clauses was to ensure that the major changes being made in the statute would not adversely affect the basic exemption of state and municipal bond interest and the other items of income to which they apply. With a tax at a marginal rate of 29.1% applicable to the receipt of state and municipal bond interest, the record in this case shows that fully taxable corporate bonds with their higher interest rates would be a more attractive investment to respondent under normal market conditions (R. 44-45.)

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[38] The study reported in The National Underwriter, March 6, 1965, p. 22, found that there would be no inducement for companies paying 90 percent of the tax paid by the life insurance industry to increase their investment in state and municipal bonds if interest on such bonds were eliminated by the adjustments from the computation of their Federal income tax liability.

Only 2.8% of the assets of United States life insurance companies was invested in state and local bonds in 1958; in 1963, the figure was 2.7%. Institute of Life Insurance, *Life Insurance Fact Book 1964*, p. 73.

Conclusion

The repeated assurances in the committee reports and the legislative debates that state and municipal bond interest would not be taxed under the bill containing the adjustment clauses leave no doubt that Congress intended to preserve the immunity of state and municipal bond interest from Federal taxation as traditionally understood by all. It was made unmistakably clear in the hearings before the Senate Finance Committee which added the adjustment clauses to the bill that the immunity which was to be protected was the immunity that was given effect in *National Life*. Congress did not intend that the traditional immunity enjoyed by state and municipal bonds should be "chipped away" and destroyed by the disallowance of deductions or by the use of a sophisticated formula for dividing a life insurance company's income between the "policyholders' share" and the "company's share", the operation of which would vary with the receipt of state and municipal bond interest.

Sections 804(a)(6) and 809(b)(4) were added by Congress to ensure that interest on state and municipal bonds would continue to enjoy their full immunity from Federal taxation in the hands of life insurance companies. This can be done only if, as determined by the Court below, the adjustment clauses are interpreted in accordance with Congressional intent and invoked to eliminate any increase in tax that would result from the receipt of state and municipal bond interest by life insurance companies.

The decision of the United States Court of Appeals for the Tenth Circuit should be affirmed.

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APPENDIX A

THE TAXATION OF LIFE INSURANCE COMPANIES

Under Section 802(a) of the Internal Revenue Code of 1954, added by the Life Insurance Company Income Tax Act of 1959, a tax is imposed at ordinary corporate rates on the "life insurance company taxable income" of companies subject to the Act. The determination of "life insurance company taxable income" as defined in Section 802(b) involves three separate computations, which are often referred to as phases 1, 2 and 3. In addition, long-term capital gains are taxed separately.

The phase 1 computation determines "taxable investment income" and starts with a calculation of "investment yield". "Investment yield" is defined as gross investment income less investment expenses. Section 804(c). Gross investment income includes interest (whether taxable, partially tax-exempt, or fully tax-exempt), dividends, rents, royalties and other investment-type income. Section 804(b). Investment expenses include general investment expenses (subject to certain limitations) and other expenses not attributable to insurance business. Section 804(c).

"Investment yield" is next divided into two shares, the "company's share" and the "policyholders' share". The "policyholders' share" is excluded and only the "company's share" of "investment yield" is included in "taxable investment income". Sections 804(a)(1) and (2). The "policyholders' share" is a percentage determined by dividing "investment yield" into the

"policy and other contract liability requirements". Section 804(a)(1).

"Policy and other contract liability requirements" is determined under the complex formulae provided in Section 805 by multiplying the company's "adjusted life insurance reserves" by the "adjusted reserves rate", which is the lower of its current earnings rate or its average earnings rate for the current year and the four preceding years; in addition, pension plan reserves are multiplied by the current earnings rate and there is added the interest paid during the year. Section 805(a). The earnings rates used in this computation are determined by dividing "investment yield" for each year by the mean of the company's assets for such year. Section 805(b). The company's "adjusted life insurance reserves" are its life insurance reserves required by law, other than pension plan reserves, adjusted for the difference between the assumed interest rate used in computing such reserves and the company's actual earnings rate. The reserves are adjusted upward by one percent for every tenth of a percent by which the "adjusted reserves rate" is less than the assumed rate; if the "adjusted reserves rate" exceeds the assumed interest rate, the reserves are adjusted downward in a similar manner. Section 805(c). In these computations, a reduction in the "adjusted reserves rate" because of a smaller "investment yield" results in an upward adjustment in arriving at "adjusted life insurance reserves".

The general purpose of these computations is to determine the amount which, on the basis of the com-

pany's own investment experience, is need to satisfy its liabilities on its insurance contracts.

After the "policyholders' share" percentage is determined by dividing "investment yield" into "policy and other contract liability requirements", the remaining portion of 100% is the "company's share". Section 804(a)(2). Thus if "investment yield" increases relative to "policy and other contract liability requirements", the "company's share" percentage increases; if "investment yield" decreases, the "company's share" percentage decreases, but it is never below zero. The "company's share" percentage is then applied to "investment yield" to determine the portion of investment income that is included in "taxable investment income". Section 804(a)(2). The effect is to include in the company's taxable income only the amount of "investment yield" in excess of the "policy and other contract liability requirements." The final computation in determining "taxable investment income" is to deduct from the company's share of "investment yield" its share of tax-exempt interest, deductions for partially tax-exempt interest and dividends received in respect of its share of such items, and finally a small business deduction. Section 804(a)(2).

Section 804(a)(6) provides that if it is established in any case that the foregoing computation of "taxable investment income" results in the imposition of tax on any tax-exempt interest, or on certain other items, an adjustment shall be made to the extent necessary to prevent such imposition.

The phase 2 computation determines "gain from operations" under Section 809. The "company's share" and the "policyholders' share" percentages are computed in the same manner as in phase 1, except that "investment yield" is divided into "required interest" instead of "policy and other contract liability requirements". Sections 809(a)(1) and (b)(3). "Required interest" is determined by multiplying the company's reserves by the assumed interest rates used by the company in computing its reserve liabilities. Section 809(a)(2). "Required interest" is thus the amount that the company assumes it must earn from its investments in order to meet the annual increases in its contractual liabilities to policyholders. After the "company's share" percentage is determined, it is, as in phase 1, applied to "investment yield". Section 809(b)(1). The amounts thus determined are then added to premium receipts and other income, and there are deducted claims, increases in certain reserves,* regular corporate expenses, the company's share of tax-exempt interest, deductions for partially tax-exempt interest and dividends received in respect of the company's share of such items, the small business deduction, and other special deductions. Section 809(d). The special deductions, which relate to policyholder dividends on participating insurance policies and special allowances for nonparticipating policies and group insurance, cannot reduce "gain from operations" to an amount that is smaller than "taxable

* The deduction for increases in reserves is reduced by the amount of the "policyholders' share" percentage of "investment yield not included in gain or loss from operations". Sections 810(a) and (b).

investment income" by more than $250,000. Section 809(f).

As in phase 1, if it is established in any case that this computation of "gain from operations" results in the imposition of tax on tax-exempt interest or certain other items, an adjustment is required to prevent such imposition. Section 809(b)(4).

Where "gain from operations" determined under phase 2 exceeds "taxable investment income" determined under phase 1, 50 percent of such excess is added to "taxable investment income" in computing "life insurance company taxable income". Section 802(b)(1) and (2). If "gain from operations" is less than "taxable investment income", only "gain from operations" is included in "life insurance company taxable income" and "taxable investment income" is ignored. Section 802(b)(1).

The phase 3 computation is designed to include in "life insurance company taxable income" after 1958 the 50 percent of the excess of "gain from operations" (phase 2) over "taxable investment income" (phase 1) which has not been included in "life insurance company taxable income" at the time it was earned. Section 815. It is not applicable in this case.

The regular 52 percent corporate tax is imposed on "life insurance company taxable income" (with the 30 percent rate applying to the first $25,000). Section 802(a)(1). A separate 25 percent tax is imposed with respect to net long-term capital gains in excess of net short-term capital losses. Section 802(a)(2).

APPENDIX B

ADJUSTMENTS ORDERED BY THE COURT OF APPEALS

A step-by-step comparison of petitioner's computation of respondent's tax liability and the computation of respondent's tax liability after making the adjustment excluding state and municipal bond interest as ordered by the Court of Appeals may be found at the end of this appendix. The computation may be summarized as follows (parenthetical references are to the comparison):

In petitioner's computation, to arrive at a "company's share" percentage of 14.6636% in "phase 1", petitioner divided "investment yield" of $894,277.61, which included respondent's state and municipal bond interest of $36,637.79, into "policy and other contract liability requirements" in the amount of $763,144.28, and subtracted the result from 100%. (Phase 1, items 7 and 8.) Disregarding respondent's tax-exempt interest in this computation, as the Court of Appeals ordered, "investment yield" is reduced to $857,639.82. (Phase 1, item 1.) Dividing that amount into "policy and other contract liability requirements", which is reduced to $743,137.55 because of the lower earnings rates resulting from the exclusion of tax-exempt interest from the determination of such rates, the "company's share" percentage is 13.3509%. (Phase 1, item 8.) Thus, 1.3127% of the 14.6636% determined by petitioner was attributable to respondent's tax-exempt interest. Petitioner applied 14.6636% to both the taxable and tax-exempt items of

respondent's "investment yield", thereby determining that $125,760.87 of the taxable items and $5,372.42 of the tax-exempt items or a total of $131,133.29 of "investment yield" were includible in "taxable investment income" before deducting tax-exempt interest. (Phase 1, item 9.) Both of these amounts were directly increased by the use of the 14.6636% "company's share" percentage instead of 13.3509%. Petitioner then deducted the $5,372.42 of tax-exempt interest, but the $125,760.87 was included in "taxable investment income" without any modification for the increase of $11,258.60 of taxable items of "investment yield" included in "taxable investment income" solely because of the 1.3127% increase in the "company's share" percentage resulting from the inclusion of tax-exempt interest in "investment yield". (Phase 1, item 10.) If 13.3509%, the percentage determined without regard to tax-exempt interest, is used, the amount of "investment yield" taxable to respondent is $114,502.27, and after the small business deduction respondent's "taxable investment income" is $89,502.27 instead of $100,760.87 as determined by petitioner. (Phase 1, items 9 and 11.)

In the adjustments ordered by the Court of Appeals, the exclusion of tax-exempt interest from "investment yield" in determining the earnings rates in phase 1 resulted in a reduction of the "policy and other contract liability requirements".* If tax-exempt interest had

* Tax-exempt securities were not excluded from respondent's assets in determining the earnings rates. This would unduly increase earnings rates thereby reducing the tax on the taxable items of respondent's investment income.

not been excluded from this computation, the "company's share" percentage in phase 1 would have been further reduced from 13.3509% to 11.0181% (instead of the 14.6636% used by petitioner), and the difference in tax liability would have been even greater. By eliminating tax-exempt interest in the computations of earnings rates, the Court of Appeals has removed any advantage that might accrue in the computation of "policy and contract liability requirements" by reason of the receipt of tax-exempt interest and achieved exactly the same result as if respondent had received no earnings attributable to tax-exempt securities in 1958 or in prior years. (Phase 1, items 2-5.)

In the phase 2 computation petitioner also included tax-exempt interest in "investment yield" in determining the "company's share" percentage, and this again resulted in increasing the amount of investment income taxed to respondent. In phase 2, the percentage is obtained by dividing "investment yield" into "required interest", which was $781,540.32, and subtracting the result from 100%. Petitioner again used "investment yield" with tax-exempt interest included, or $894,277.61, as the denominator and thus determined that the "policyholders' share" percentage was 87.39348% and the "company's share" percentage was 12.60652%. (Phase 2, items 3 and 4.) If the percentage is determined without regard to tax-exempt interest, as the Court of Appeals ordered, the "company's share" percentage is 8.8731%. (Phase 2, item 4.) Thus 3.7334% of the 12.60652% used by petitioner is attributable to respondent's tax-exempt interest.

Petitioner used 12.60652% to determine that the "investment yield" includible in respondent's "gain from operations" was $108,118.54. (Phase 2, item 5(b).) If the percentage determined without regard to tax-exempt interest (8.8731%) is used, the company's share of "investment yield" is $76,099.50, and respondent's "gain from operations" is $129,201.04 instead of $161,220.08 as determined by respondent. (Phase 2, items 5(b) and 7.) This is the same "gain from operations" that respondent would have had if it had received no tax-exempt interest.

Respondent's tax liability was determined by the Court of Appeals by adding to the "taxable investment income" of $89,502.27, 50% of the amount by which the "gain from operations" of $129,201.04 exceeds the "taxable investment income" to arrive at a "life insurance company taxable income" of $109,351.66. (Tax computation, item 1.) The tax on this amount is $51,362.86. (Tax computation, item 2.) These figures compare with petitioner's determinations that respondent's "taxable investment income" was $100,760.87, its "gain from operations" $161,220.08, its "life insurance company taxable income" $130,990.48, and its tax liability $62,615.05. (Tax computation, items 1 and 2.) The difference in tax liability of $11,252.19 is the tax imposed on state and municipal bond interest which the Court of Appeals determined should be refunded to respondent.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7

Following is a step-by-step comparison of plaintiff's Exhibit 6 (R. 35, 66-72), which shows petitioner's computation of respondent's income tax liability for 1958 in which tax-exempt interest is taken into account, and plaintiff's Exhibit 7 (R. 39, 73-79), which shows the computation of the refund claimed by respondent and ordered by the Court of Appeals in which tax-exempt interest is disregarded.

Phase 1: Computation of Taxable Investment Income:

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
1. Investment Yield	$894,277.61	$857,639.82	804(e); Sch. A, Ln. 14	Investment yield is gross investment income after deducting investment expenses. Investment yield in Ex. 7 is lower than that in Ex. 6 due to the exclusion of $36,637.79 of tax-exempt interest accrued by respondent in 1958.
2. Current Earnings Rate	3.33390%	3.19731%	805(b)(2); Sch. B, Pt. III, Ln. 1	Current earnings rate equals investment yield in Item 1 divided by assets. The lower investment yield in Ex. 7 thus reduces the current earnings rate.
3. Average Earnings Rate	3.253782%	3.12297%	805(b)(3); Sch. B, Pt. III, Ln. 7	Average earnings rate is the average of the current year's earnings rate and that of the prior four years.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 1: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
4. Adjusted Reserves Rate	3.253782%	3.12297%	805(b)(1); Sch. B, Pt. I, Ln. 2, Left Col.	The adjusted reserves rate is the lower of Item 2 or Item 3 above.
5. Adjusted Life Insurance Reserves	$22,090,965.28	$22,375,659.00	805(c); Sch. B, Pt. V, Ln. 3	Adjusted life insurance reserves is the amount of reserves required by law adjusted upward by 1% for every .1% by which the assumed interest rate used in calculating such reserves exceeds the adjusted reserves rate. The adjustment is greater in Ex. 7 because the lower earnings rates, by decreasing the adjusted reserves rate, increase the difference between the adjusted reserves rate and the assumed interest rate.
6. Policy and Other Contract Liability Requirements	$763,144.28	$743,137.55	805(a); Sch. B, Pt. I, Ln. 4	This amount is computed by multiplying the adjusted life insurance reserves by the adjusted reserves rate and adding the interest paid by the company during the year. A lower

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase I: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				amount results in Ex. 7 because of the reduction in the adjusted reserves rate in Item 4 resulting from the lower earnings rates because of the exclusion of tax-exempt interest from investment yield. The effect of the reduction in the adjusted reserves rate is partially offset by the increase in adjusted life insurance reserves in Item 5.
7. Policyholders' Share Percentage	85.3364%	86.6491%	804(a)(1); Sch. C, Ln. 1	This percentage is obtained by dividing investment yield into the policy and other contract liability requirements. The percentage is smaller in Ex. 6 because tax-exempt interest is included in investment yield, despite the lower amount of policy and other contract liability requirements in Ex. 7.
8. Company's Share Percentage	14.6636%	13.3509%	804(a)(2); Sch. C, Ln. 2	This percentage equals 100% minus the policyholders' share

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 1: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				percentage in Item 7. A comparison of Exs. 6 and 7 here shows that the inclusion of tax-exempt interest in Ex. 6 results in increasing the company's share percentage.
9. Company's Share of Items of Investment Yield			804(a)(2); Sch. C, Lns. 4-8	The larger company's share percentage in Item 8 results in allocating to respondent a larger amount of taxable items of investment yield. The total figure may also be obtained by subtracting the policy and other contract liability requirements from the investment yield.
(a) Tax-Exempt Interest	$ 5,372.42	None		
(b) Other Items	125,760.87	$114,502.27		
(c) Total	$131,133.29	$114,502.27		
10. Deduction for Tax-Exempt Interest	$ 5,372.42	None	804(a)(2)(A)(i); Sch. C, Ln. 9	In Ex. 6 deduction is taken for the company's share (14.6636%) of the tax-exempt interest ($36,637.79) included in investment yield. No amount is deducted in Ex. 7 since all the tax-exempt in-

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 1: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				terest has been initially excluded from investment yield.
11. Taxable Investment Income	$100,760.87	$ 89,502.27	804(a)(2); Sch. C, Ln. 14	This figure is obtained by deducting the $25,000.00 small business deduction and Item 10 from Item 9(c).

The difference of $11,258.60 in taxable investment income between Ex. 6 and Ex. 7 is attributable to the difference in the company's share percentage in Item 8 (1.3127%) multipled by the amount of the taxable items of investment yield ($857,639.82). The higher company's share percentage in Ex. 6 results from the inclusion of tax-exempt interest in investment yield in Item 1. The inclusion of tax-exempt interest in investment yield in Ex. 6 affects taxable investment income in two ways:

A. The entire $36,637.79 of tax-exempt interest is included in investment yield, and only $5,372.42 is deducted, increasing taxable investment income by	$31,265.37
B. Since earnings rates are higher with tax-exempt interest included, the policy and other contract liability requirements is higher in Ex. 6 than in Ex. 7 thus decreasing taxable investment income by	20,006.73
The netting of A. and B. results in a net increase in taxable investment income of	$11,258.64

This amount differs slightly from the difference of $11,258.60 above because of rounding in the computation of taxable investment income.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7

Phase 2: Computation of Gain from Operations:

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
1. Investment Yield	$894,277.61	$857,639.82	804(c); Sch. A, Ln. 14	See Item 1 of the computation of taxable investment income.
2. Required Interest	$781,540.32	$781,540.32	809(a)(2); Sch. E-1, Ln. 5	Required interest is the average rate of interest assumed by respondent in calculating its 1958 reserve liability increases.
3. Policyholders' Share Percentage	87.39348%	91.1269%	809(a)(1); Sch. E, Ln. 1	This percentage is obtained by dividing the required interest by investment yield. The percentage is smaller in Ex. 6 because tax-exempt interest is included in investment yield.
4. Company's Share Percentage	12.60652%	8.8731%	809(b)(3); Sch. E, Ln. 2	This percentage equals 100% minus the policyholders' percentage obtained in Item 3. A comparison of Exs. 6 and 7 here demonstrates that the inclusion of tax-exempt interest in Ex. 6 results in increasing the company's share percentage, just as in Item 8 of the computation of taxable investment income.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 2: Computation of Gain from Operations (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
5. Company's Share of Items of Investment Yield			809(b)(1); Sch. E, Lns. 4-8	The larger company's share percentage in Item 4 results in allocating to respondent a larger amount of taxable items of investment yield. The total figure also can be obtained by subtracting required interest from investment yield.
(a) Tax-Exempt Interest	$ 4,618.75	None		
(b) Other Items	108,118.54	$76,099.50		
(c) Total	$112,737.29	$76,099.50		
6. Deduction of Tax-Exempt Interest	$ 4,618.75	None	809(d)(8)(A)(i); Sch. E, Ln. 16	In Ex. 6 a deduction is allowed for the company's share (12.60652%) of the tax-exempt interest ($36,637.79) included in investment yield. No amount is deducted in Ex. 7 since all tax-exempt interest has been initially excluded from investment yield.
7. Gains from Operations	$161,220.08	$129,201.04	809(b)(1); Sch. E, Ln. 27	The difference of $32,019.04 in gain from operations between Ex. 6 and Ex. 7 is attributable

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 2: Computation of Gain from Operations (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				to the difference in the company's share percentages in Item 4 (3.7334%) multiplied by the taxable items of investment yield ($857,639.82). The higher company's share percentage in Ex. 6 is attributable entirely to the inclusion of tax-exempt interest in investment yield in Item 1. The difference is also exactly equal to the difference between the tax-exempt interest of $36,637.79 included in investment yield in Item 1 and the $4,618.75 deducted in Item 6 as the company's share of tax-exempt interest.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Tax Computations

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
1. Life Insurance Company Taxable Income	$130,990.48	$109,351.66	802(b); Pg. 1, Ln. 3	This figure is the sum of the entire amount of taxable investment income and 50% of the excess of gain from operations over taxable investment income.
2. Total Income Tax	$ 62,615.05	$ 51,362.86	802(a); Pg. 1, Ln. 6	This amount is respondent's tax liability for 1958. Ex. 6 shows the tax liability after making the corrections on the respondent's original 1958 return agreed to by the parties but without making adjustments to prevent the imposition of tax on tax-exempt interest. Ex. 7 shows respondent's 1958 tax liability after making the adjustments under Secs. 804(a)(6) and 809(b)(4) ordered by the Court of Appeals. The difference between the tax liability on Ex. 6 and that on Ex. 7 is $11,252.19 and represents the increased tax liability for 1958 if tax-exempt interest is not entirely excluded from the tax computation.